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16 AUG 1985

MEMORANDUM FOR: Director of Central Intelligence

VIA: Deputy Director of Central Intelligence

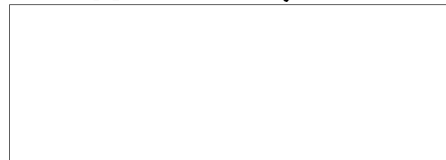
FROM: Robert M. Gates
Deputy Director for Intelligence

SUBJECT: 1986 Research Program

1. In response to your 3 August memo proposing that we do some work on the global financial structure, OGI will include a new project to be completed in the second quarter under the cross-cutting theme on The Changing Structure of the World Economy.

2. We have indeed done many of the building block pieces that would go into a broad assessment of the major changes in international financial flows, and I share your view that we need to look at how they are related and what they portend for the future.

3. Attached is a brief concept paper outlining the general approach OGI plans to take. I would appreciate your reaction to it.



Robert M. Gates

Attachment:
Concept Paper

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Changes in the Global Financial System: Impacts and Implications

In the 1980s we have seen a dramatic increase in international capital flows to finance debt, budget deficits, financing, and trade financing. Global government and commercial transactions now total nearly three-quarters of a trillion dollars every day. Moreover, financial decisions have ramifications well beyond the economic realm, and the transactions can be carried out within minutes. [REDACTED]

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As evidence of the power of financial decisions in today's environment, capital flows more than trade flows are determining exchange rates. Thus, in 1982-84 the dollar continued to rise sharply despite the increase in the US trade deficit. And the strong dollar is now aggravating the trade imbalance and contributing to the loss of US competitiveness. As a result, trade policy has become a major political issue in many countries, and protectionist pressures are mounting on numerous fronts. [REDACTED]

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One of the most notable developments has been the influx of Japanese capital into the United States--now the largest bilateral capital flow in the world. Instead of investing more at home, which could boost demand for imports, the Japanese are increasingly using their excess savings to invest in US industries and to buy US Treasury obligations. While a reversal of this trend does not appear imminent, one could conjure up circumstances under which, for example, the Japanese no longer found US Government securities an attractive asset. This might lead to a crisis of confidence in financial markets, setting off a chain of events that would almost certainly have negative consequences for the world economy, including higher interest rates and slower US economic growth. [REDACTED]

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The rapid changes in and uncertainty surrounding the global financial structure are placing greater demands on the world's political leaders. Bankers' decisions can now affect not only the direction and level of a country's economic activity but its political stability as well. Banks' pressure on LDCs to meet increased debt service expenses, for example, has forced LDCs to cut imports and to slow economic growth. Austerity measures have, in turn, led to social unrest in many of them. [REDACTED]

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With international finance playing a larger role in political decisions, policymakers are confronted with highly complex issues that pose difficult problems. On the one hand:

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- o Protectionist pressures in both the industrial and developing nations could jeopardize the effort to open up world markets through a new round of trade negotiations, cause political recriminations that could thwart agreement on strategic matters such as defense, and threaten the international financial system because of the desperate need of debtors to export.
- o As long as the net outflow of capital from the Third World continues, there is the danger of long-term recession, de-development, and political instability in the debt-troubled LDCs.
- o US companies are being forced to locate more and more of their production facilities abroad in order to compete in world markets. This will not only increase trade protectionism but make it more difficult to control the sale of strategic high-technology items to the Communist countries. [REDACTED]

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On the other hand, the importance of access to the huge US market combined with the clout of the United States as a world money center gives us some opportunities. For example:

- o The threat or actual use of protectionist measures can be a powerful tool in negotiating trade concessions.
- o Money-strapped LDCs could be persuaded to open up their economies to private foreign investment. Although it might be small in volume, its catalytic effect on domestic investors could be dramatic.
- o Technology diffusion could be a plus if it were accompanied by quid-pro-quos for opening up markets to US goods and investment. [REDACTED]

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This paper will examine the interrelationships among financial, investment, and trade flows. The primary focus will be on assessing the impacts of what has occurred, what might happen if major new shifts take place, and what these developments mean for policymakers in the United States and various other countries. [REDACTED]

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SUBJECT: 1986 Research Program

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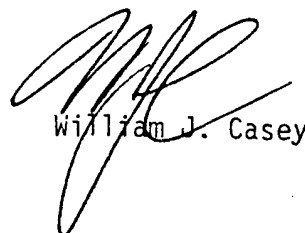
MEMORANDUM FOR: Deputy Director for Intelligence
FROM: Director of Central Intelligence
SUBJECT: 1986 Research Program

1. I have found the cross-cutting themes in the 1986 research program very impressive.

2. Reading it gives me the occasion to suggest that we ask OGI to do some work on the global financial structure and interrelationships between its key elements and the leverages and the vulnerabilities it creates for various countries. As I see it, the key elements are the trade deficits and the potential for protectionist measures which they engender, the foreign investment flow, together with the budget deficits and the financial vulnerability which could come from withdrawals of funds or other elements of the financial flow, e.g. heavy Japanese investments in other countries, the foreign debt overhang, the relative value of currencies, particularly the dollar, and the trade implications, as well as the financial vulnerabilities which might occur from abrupt changes in relative values, the implications of the drift of production capabilities and technology from one country to others, notably the US, Japan and Europe, subsidy in market targetting and other trade promotion policies, etc.

3. We have done work on most of the above separately. We should take a look at their interrelationships in the context of the total global economic, financial and political structure. Let's talk about who could take the first shot at formulating the framework for this kind of an undertaking.

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taller to
me about
this.
Rg.*


William J. Casey

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